DOW THEORY LETTERS INC.

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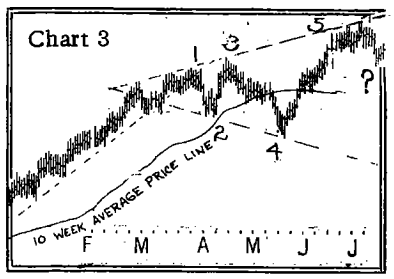
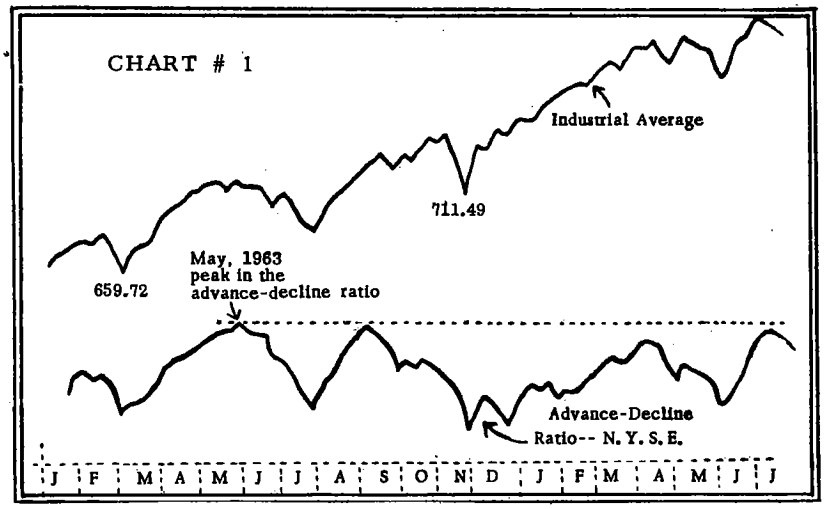
THE MARKET: On July 17 the two D-J Averages, Industrials and Rails, recorded historic highs of 851.35 and 220.98 respectively. Since then the two indicators have dipped in what could be part of an (overdue) minor correction — or the beginning of something more serious.

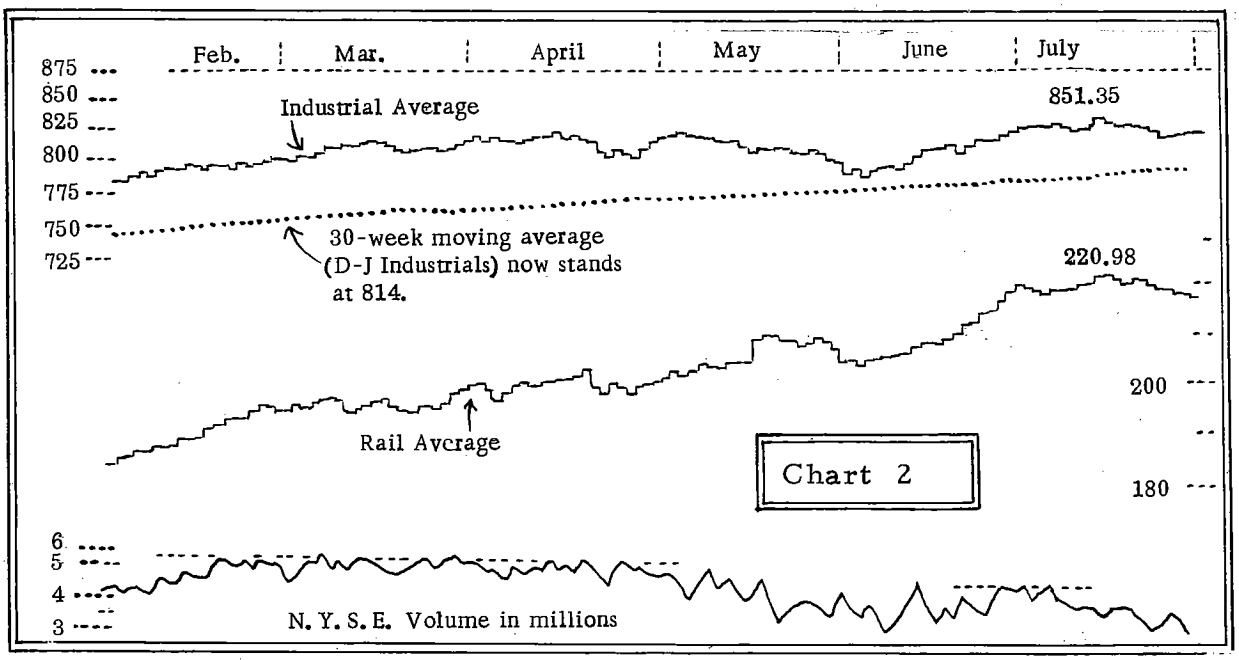
THE BULL ARGUMENTS: Under Dow Theory, a trend is taken to remain in force until proved otherwise. The last established trend was bullish: the bull trend has not yet been reversed. Since the peak in the Averages recorded two weeks ago, the two indicators have drifted lower, but volume has contracted dramatically on the decline. The Averages have now slid under their July lows; nevertheless, Industrials are still 25 points above their 30-week moving average (chart 2), while Rails have given ground grudgingly (although the carriers are certainly entitled to correct part of their explosive June advance). Finally, in the face of the Vietnam situation, the possible sterling crisis in England, the race riots in this country, and the gathering recognition of Goldwater's improving Presidential chances, the market is behaving well — if not downright bullishly. The burden of proof continues to rest with the bears.

THE BEAR ARGUMENTS: The entire bull market (having started in 1949) is now ancient. It has become dangerously extended and values have become dangerously "thin". Furthermore, the advance since June, 1962, is now quite old. The 1962-64 advance has continued virtually uncorrected (uncorrected in the sense of the normal 1/3 to 2/3 retracement), and even the bulls must concede that such a correction is now overdue. Finally, we must recognize the fact that Wall Street has been flooded by rosy business news and optimistic forecasts during 1964. Yet as of this writing, the Industrial Average has been able to push only 4% beyond its first quarter peak of 820.25 (recorded March 18). The market has become unresponsive to good news, suggesting that the major portion of the good news has already been discounted.





PHENOMENA WHICH SHOULD BE WATCHED IMPARTIALLY BY BULLS AND BEARS: Volume during the March-April advance struck a (10-day average) peak of almost 6 million shares



(chart 2, page 1). But on the latest July-August rise, peak volume averaged less than 5 million shares. Volume frequently turns down before price. Therefore, it will be important to see whether March-April represented the peak volume period or whether any forthcoming advance will push volume figures to bullish new highs.

As seen on chart 3 (page 1), the Industrial Average has formed a classic "broadening structure". On July 18 the Industrials turned down from point 5 on this structure. The fact that the decline did begin at point 5 could be a mere (innocent) coincidence or it could be the beginning of the completion of an ominous "broadening top".

The advance-decline ratio turned down on July 20 — in the precise area (Chart 1) from which it turned down on three previous occasions. Again, this could be mere coincidence, but it will nevertheless be worth scrutinizing the action of the A-D ratio from this point on.

HOW TO RECOGNIZE TROUBLE: Keeping in mind the fact that the bull trend will remain in force until proved otherwise, what do we watch for proof of a downturn? If the market runs into trouble, I would expect the following danger signals to present themselves: (1) Industrials will break below their 30-week moving average which now stands at approximately 814. (2) Industrials will break below the June low of 800.31 (3) Rails will confirm by first breaking below their July 9 low of 217.41, then breaking their June low of 201.83. (4) Volume will tend to expand on decline, while tending to contract on rallies.

HISTORY'S MOST EXTRAORDINARY THIRD PHASE: The history of all major bull markets is one of three fairly distinct psychological phases. The first phase is the rebound from the depressed conditions of the preceding bear market. The second phase is characterized by a steady improvement in the economy and an accompanying rise in the stock market. Here general recognition is given to the fact that a broad expansion in business is underway. The second phase of a bull market is often terminated by a particularly deceptive or violent secondary reaction. The third phase of a bull market is traditionally the speculative phase — wherein the public finally recognizes what the professionals and businessmen have known ever since the new bull market began. The third phase is the most exciting phase for it is here that the public definitely joins the parade, bringing with it volume, highly speculative moves in many stocks, and ultimately low yields and great overvaluation in equities.

Robert Rhea wrote a great deal about the three phases, and he believed that it was most important for market students to attempt to identify each phase. Nevertheless, he recognized the difficulty of this procedure when he wrote: "There is no way of defining precisely when one phase ends or another begins, but the general characteristics are not hard to define. Opinions may differ as to the day or week when mild spring weather gave way to hot summer days, but there is little dispute about a sizzling July day when the thermometer is in the high '80's."

Rhea's description of a bull market's third phase was clear enough: "The third and final stages of past bull markets have been typified by excessive activity (relative to preceding stages). The final stage is sometimes recognizable because people then buy stocks simply because they go up, and because other people are buying them. They consider it old fashioned to regard earnings and prospects. Speculation is rampant. In-and-out traders exchange their patched pants for gaudy atire, and become boardroom oracles. We soothsayers get to explaining why there will never be another bear market."

As to the relative length of each phase, Rhea frequently referred to "the second, and longest, phase", thereby implying that the first (accumulative) phase and the third (distributive) phase of a bull market consumed less time than the middle or second phase.

A study of history will verify that observation. The 1921-29 bull market saw a first phase which lasted from 1921 to 1923, a second phase going from 1923 to 1926, and (following a severe secondary reaction in 1926) a third phase stretching from late-1927, to 1929.

The 1932-37 bull market was characterized by a first phase lasting from 1932 to 1933, a second phase from 1933 to mid-1936, and a final speculative phase carrying from about the third quarter of 1936 to the final top in March, 1937.

The 1942-46 bull market began during the depths of World War II. Its first phase lasted from 1942 to late 1943, the second phase continued from 1944 to 1945. The final phase of the 1942-46 bull market was short and explosive, lasting from late-1945 to the second quarter of 1946.

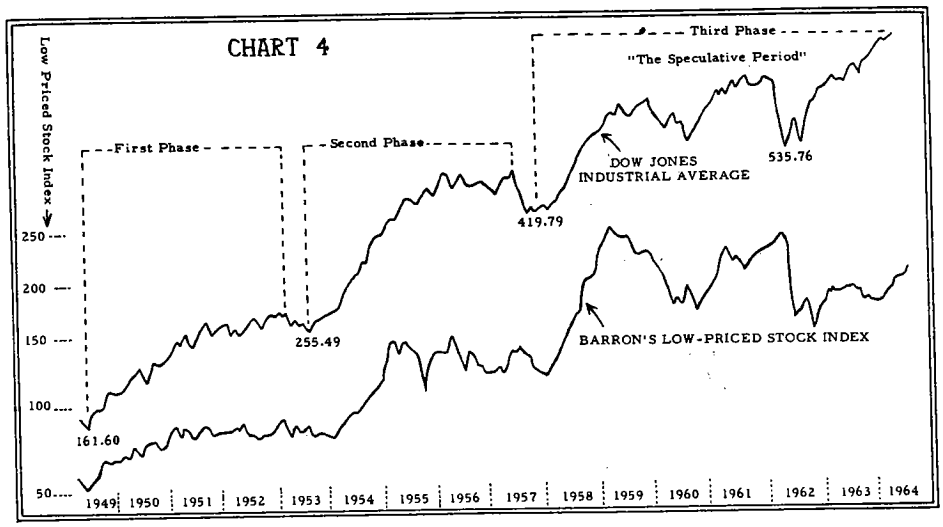
To sum up, each of these major bull markets ran true to form, having a short first phase, an extended second phase, and a short, highly speculative third phase "blow-off".

Now we come to the amazing bull market which began on June 13, 1949. This bull market has been unprecedented in many ways, not the least of which is that its third or speculative phase has lasted fully as long as its first and second phases combined. The first phase began in 1949 and continued to early 1953. A secondary reaction started in January, 1953, and carried into the fall. The bull market resumed in September, 1953, and the new rise marked the beginning of the second phase. The second phase continued almost uninterruptedly until April, 1956. From April, 1956, to October, 1957, a particularly complex and vicious secondary reaction served to correct the 1953-56 rise. The market turned up in October, 1957, and it was here that the speculative third phase was born.

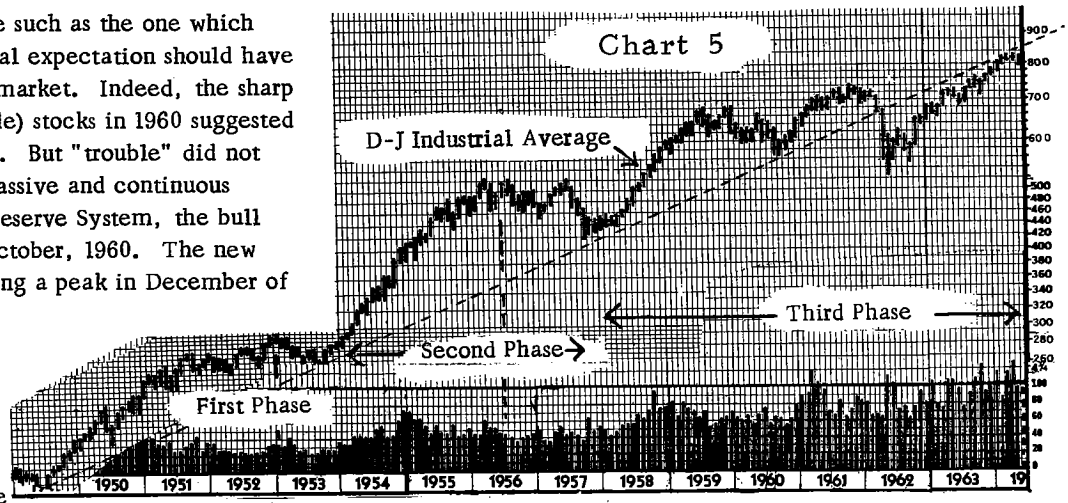
If the first and second phases of the bull market lasted approximately seven years (from 1949 to 1956), it can be stated that the third phase has now lasted (albeit with a few violent interruptions) from 1957 to the present — another seven years! Why this

unorthodox time span? What does it mean?

I have included chart 4 and 5 in an attempt to clarify the entire picture as it has unfolded since 1949. Chart 4 shows the D-J Industrial Average superimposed upon Barron's Low-priced Stock Index. Since low-priced stock activity is an excellent gauge of speculative interest, this chart is valuable in that it delineates the various phases of the bull market. Note that from 1949 to 1957, the low-priced stocks failed to keep up with the high-grade D-J Industrials. But with the start of the third phase of the bull market in late-1957, the low-priced issues began making up for lost time.



Following a great speculative surge such as the one which occurred during 1957-59, the normal expectation should have been for a termination of the bull market. Indeed, the sharp drop in low-priced (and better grade) stocks in 1960 suggested that the bull market was in trouble. But "trouble" did not signify the end. Perhaps due to massive and continuous infusions of credit by the Federal Reserve System, the bull market revived and turned up in October, 1960. The new advance continued into 1961, striking a peak in December of that year.



The year 1962 was greeted by a shattering crash in the spring, a move which saw the Averages and the L-P Stock Index break through their 1960 lows. The 1962 collapse ended in June, following which the Averages turned up again. The rise since 1962 has pushed the Industrial Average well above its 1961 high, although Barron's L-P Stock Index has not yet bettered either of its preceding peaks (this, by the way, is not true of Standard & Poor's L-P Stock Index which in 1964 rose to an all-time high).

Nevertheless, the fact is that despite the 1959 peak and subsequent reaction, despite the 1961 peak and subsequent crash, despite the collapse of hundreds of lesser quality stocks during 1960-62, the bull market has still managed to hold itself intact.

Chart 5 presents the picture from another viewpoint. Here we see the steady rise of monthly volume since 1949. Note that volume from 1949 through 1957 was consistently low, characteristic of the first two phases of a bull market. But from 1958 to the present volume has pushed steadily higher, thus offering strong evidence in support of the "continuing third phase" thesis. On Chart 5 we also note that the 1962 crash succeeded in violating the great rising trendline, a trendline which "measured" the growth rate of the bull market from 1949 to 1962. Despite the 1962 crash and despite the shattering of the trendline, the Industrial Average (since June, 1962) has pushed persistently higher, to the accompanyment of a record volume of transactions. It is interesting to observe, however, that all of the action since 1962 has taken place below the great trendline, and that the previous rate of ascent has not been captured again.

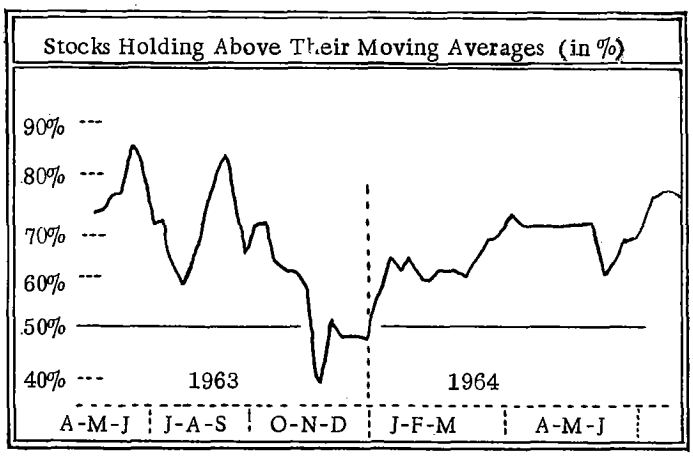
Again the question: what is the meaning of a third phase which has lasted as long as the first two phases together (actually, it has lasted longer than most previous entire bull markets)? One obvious answer is that the current situation is dangerous, if for no other reason than that it has continued so far beyond the "normal" expectation. Another consideration is that the great extension of this bull market's third phase has produced a good deal of "tiredness and strain" in terms not only of stock action but in terms of social and political phenomena.

For instance, today we have a remarkable situation in which our young adults (for the first time in history) have grown up and matured entirely within a boom period. This era of what many consider "perpetual good times" has almost certainly contributed to: (1) A wide-spread (actually international) feeling of boredom and purposelessness, as expressed first in the "beatnik" trend, currently in the "new wave" films from France, Italy, Sweden and our own Greenwich Village. (2) A world-wide epidemic in all types of crimes. (3) The jettisoning of many conservative mores, as for instance, a willingness by governments, corporations and individuals to assume heavy debt loads, a trend to semi-nudity in public, great stress on sex (without love)

in literature and in real life, a rise in the divorce and unmarried-mother rate, an inundation of sensational and pornagraphic literature, a rise in youthful resentment against authority as expressed through attacks on teachers, policemen, etc. (4) A general air of euphoria and a growing faith in the government's ability to solve and take care of all problems. (5) A belief that hard times and cyclical extremes are a thing of the past. (6) A yearning among a certain segment of the population for "the simpler, fundamental truths of the past" as expressed (rightly or wrongly) by the current Republican candidate for the Presidency, Barry Goldwater.

How does all this affect the stock market? I believe the unprecedented spectacle of a bull market third phase which has survived seven extraordinary years is being reflected in the erratic character of current stock movements. Trends have tended to lose their clarity; the public is apathetic or confused and does not seem to become thoroughly bullish or bearish; analysts are working harder in the market but producing less satisfactory results; many indicators are providing false or confusing signals; movements of individual stocks are sporadic or deceptive; traditional market leaders such as steels no longer lead; dozens of investment services and systems are springing up, each offering to analyze and re-analyze a market which by traditional yardsticks is simply "too high" and has been too high for too long.

STOCKS: Of 432 representative stocks tabulated here weekly, 323 (75%) are now holding above their 30-week moving averages, a drop of 1% from last week. As long as the percentage holds above 50%, this "breadth study" remains bullish.



After reviewing daily and weekly charts of hundreds of stocks this past weekend, I have decided to be most wary about recommending even trading purchases at this time. The majority of stocks on the N.Y.S.E. are now moving sideways or retreating from recent highs. One of the commonest patterns on the Board at this time is the "double top". Here the stock rises to a high on good volume, retreats for a few weeks, then pushes up on lower volume to the vicinity of the first high. The stocks may even better the first peak (as in Chrysler or GM) but buying "interest" (volume) is not forthcoming and the stock falters and drifts off.

A second important phenomenon is the weakness of some of the widely-followed market leaders. IBM turned distinctly weak when it broke the 460 level. Thus this institutional favorite rose just under its 1961 peak during 1964 — then turned down with a vengeance. Pan American, the volume leader in the Airline group, has now broken its two-year rising trendline, and also looks like a sale. Xerox (in the weakening office equipment group) also has violated its long rising trendline and has broken below a triangle which can be easily seen on the weekly chart below. Compact triangles (of the type pictured on the Xerox chart) can have real power when they break, and this is particularly true when the break comes before the tip or apex of the triangle. Note the significant volume contraction in Xerox during 1964. Burroughs (recently recommended) is probably being affected by the weakness in the office equipment group. The stock has retreated to its 200-day moving average, but I believe it would take a good deal of selling pressure to push it back into its base at 22. A break below 22 would be the give-up point, but I do not foresee this unless we are now moving into a bear market.

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Chart of Xerox courtesy of Traders Research, 1431 Pearl Avenue, Alton, Ill. 62003.
Chart 3 and charts of BGH, PN, IBM courtesy of Quote Digest, 110 North Lorraine, Wichita, Kansas.
Chart 5 courtesy of Security Research, 211 Congress Street, Boston, Massachusetts.